Philippines

Higher than expected economic growth in the first half of 2010 was driven by strong domestic investment and industrial output, helped by external demand. Consumption (both private and government) continued to expand. Economic growth will likely ease in the second half, but given the strong January–June outcome, the forecast for the full year is raised from April's *Asian Development Outlook 2010 (ADO 2010)*. Growth next year will still decelerate from this year's pace, as anticipated in *ADO 2010*. Inflation has been moderate and is expected to remain so. The current account is forecast to record solid surpluses.

Updated assessment

Recovery in the first half of 2010 was stronger than expected, with GDP increasing by 7.9%, compared with growth of just 0.9% in the first half of 2009. The pace of growth quickened marginally from the first quarter to the second (Figure 3.8.1). Consumption, investment, and net exports all contributed to growth in the January–June period.

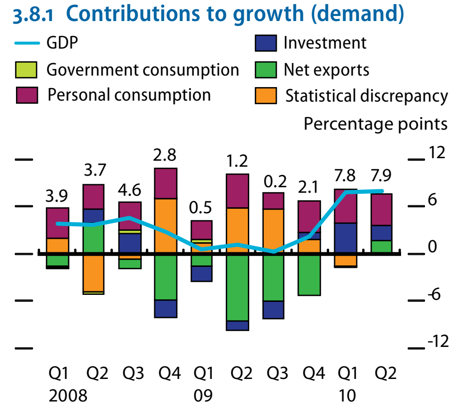
Private consumption grew by 5.1%, largely on account of increases in spending on food and drinks, utilities, and transportation. Remittances from overseas workers remained a key support of consumption, growing by nearly 7% to $9.1 billion (the increase in peso terms was 2.2%). About half the total GDP growth in the first 6 months came from the lift in private consumption.

Investment made a significant contribution to GDP growth for the first time since 2007. Outlays on fixed capital investment surged by just over 21% year on year, with equipment investment rising by 30% from low prior-year levels. Strong growth was recorded in spending on commercial vehicles, industrial machinery, and telecommunications equipment. Fixed investment as a ratio to GDP rose to 17.2%, the highest level in 7 years (Figure 3.8.2).

Government expenditure also climbed in the first half, in part a consequence of presidential and legislative elections in May 2010. The government raised spending on social protection programs that include conditional cash transfers to poor families who commit to keep children in school, and on infrastructure, notably reconstruction of typhoon-damaged facilities. Net exports of goods and services made just a small contribution to GDP growth, reflecting a strong rise in imports that accompanied the recovery in exports.

From the production side, GDP growth was driven by a rebound in industry, notably manufacturing (representing 66% of the sector), where output rose by 16.2% from depressed prior-year levels. Export-oriented electronics manufacturers did particularly well as export demand rallied. In other industry categories, construction (17% of the sector) expanded by 15.7% and mine production (8%) rose by a rapid 23%, supported by

3.8.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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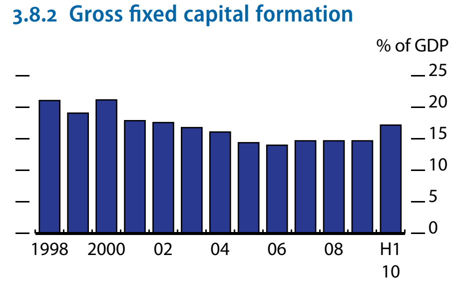
3.8.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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This chapter was written by Teresa Mendoza and Norio Usui of the Philippines Country Office, ADB, Manila.

the recovery in global demand and higher metals prices. Industry as a whole contributed 5.0 percentage points of the total 7.9% GDP growth (Figure 3.8.3).

Services, the biggest sector of the economy, grew by 6.7% in January–June 2010. However, agriculture contracted by 2.9%, mainly owing to dry weather caused by an El Niño weather pattern. The dry spell was so severe that it cut agricultural employment by 802,000, offsetting much of the employment generated by industry and services. Consequently, the unemployment rate rose to 8.0% in April 2010 from 7.5% in April 2009. Underemployment accounted for another 17.8% of the workforce. As a mark of the broad-based scarcity of jobs, about 20% of the unemployed have college degrees.

Inflation edged higher (Figure 3.8.4) to average 4.2% in the first 8 months of 2010, although price pressures were generally milder than anticipated in April at the launch of *ADO 2010*. A 2.8% appreciation of the peso against the US dollar over this period helped to shield the economy from imported inflation. Bangko Sentral ng Pilipinas, the central bank, withdrew several liquidity-enhancing measures it had implemented during the global financial crisis. It did, though, maintain the low policy interest rates it had brought in during the crisis—4.0% for the overnight borrowing rate and 6.0% for the overnight lending rate.

Merchandise exports on a US dollar basis rose steeply each month, from low prior-year levels, to be 38.5% higher in the first half (Figure 3.8.5). Exports were propelled by a near 50% jump in shipments of electronic products. Imports increased by 29.7% in the first half, reflecting the stronger demand for capital equipment and consumer goods, and the need to supply imported inputs for export-oriented manufacturing industries.

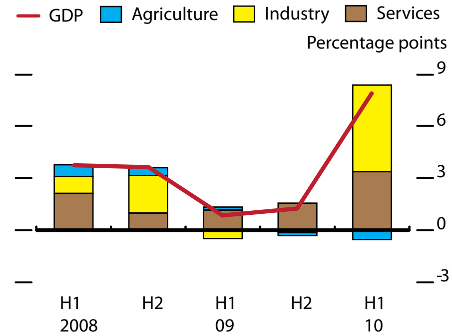
The deficit in merchandise trade narrowed slightly in the first half of 2010 to $4.8 billion, owing to the steeper rebound in exports than imports. However, the surplus in services trade fell to $1.0 billion as higher net outflows on services such as transportation more than offset rising income from business process outsourcing. After taking into account remittances, the current account surplus rose to $4.4 billion, equivalent to 5.0% of GDP.

Portfolio investment recorded net outflows of $1.2 billion, in large part reflecting investors' global risk aversion as a result of the European sovereign debt crisis. Net foreign direct investment fell to just $445 million. Still, the capital and financial account posted lower net outflows of $192 million in January–June 2010 (net outflows were $2.6 billion a year earlier), owing to improvements in trade credits and other flows. The overall balance of payments recorded a larger surplus ($3.3 billion).

External surpluses buoyed the peso and lifted gross international reserves to $49.6 billion in August, representing 9.2 months of import cover and 9.5 times short-term external debt based on original maturity. The buildup in reserves also reflected government borrowing abroad to fund its spending.

Government expenditure rose by 13.3% in the first 7 months of 2010 (excluding interest paid on the national debt), outpacing a 10.3% increase in tax revenue. The fiscal deficit for the first half widened to the equivalent of 4.9% of GDP (Figure 3.8.6).

3.8.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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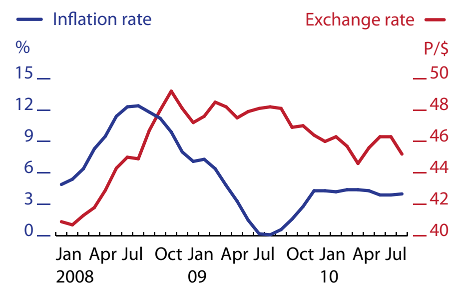
3.8.4 Inflation and exchange rate



Sources: National Statistics Office. http://www.census.gov.ph; Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph (both accessed 3 September 2010).

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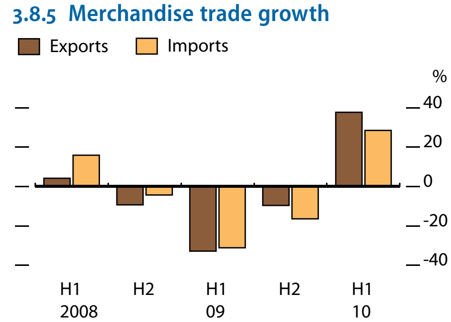
3.8.5 Merchandise trade growth



Note: Based on balance-of-payments data.

Source: CEIC Data Company (accessed 27 August 2010).

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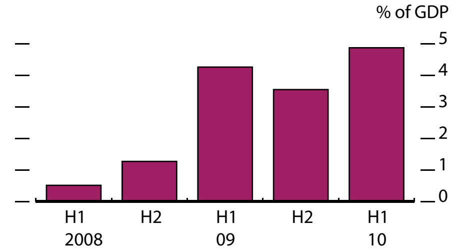
The new government, taking office on 30 June, said it aims to limit the full-year fiscal gap to 3.9% of GDP, the same level as 2009, by tightening expenditure in some areas and more determined tax administration. Certainly, the stronger than expected GDP growth will support the revenue-raising effort, and there are signs of expenditure restraint (noninterest outlays fell by 1.3% year on year in July).

The 2010 gross borrowing program has been expanded to about 9% of GDP, from 7.5% in 2009. Approximately one-third ($5.5 billion) is to be sourced from abroad, with about $4 billion on commercial terms and the rest in official assistance. Notwithstanding the expected higher borrowing, yields on government securities in the first 8 months edged lower than in the prior-year period. Also, the yield spread between the US and Philippines Treasuries narrowed from the peaks of 2008 and 2009. Ample liquidity in the domestic market and a robust external position helped counter concerns over fiscal weakness.

Bank lending to both consumers and businesses has expanded during 2010, with growth in credit for production activities picking up to 12% year on year in July (the highest rate of growth since June 2009). Bank capital-adequacy ratios are well above 10%, while nonperforming loan ratios remain in the low single digits.

3.8.6 Fiscal deficit



Source: CEIC Data Company (accessed 9 September 2010).
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Prospects

The incoming government has signaled the following broad economic policies. First, it targets reining in the fiscal deficit from 3.9% of GDP in 2010 to 2.0% by 2013 and then to keep it at that rate through 2016. Stronger efforts at tax collection, prudent expenditure and liability management, and sales of public assets are intended to help achieve this goal. The government will also push for a fiscal responsibility law that would require legislators who support new appropriations or revenue-eroding bills to identify sources of funding or offsetting cuts in expenditure.

Next, it aims to trim government debt from about 57% of GDP in 2010 to 52% in 2016. The debt-management strategy also includes strengthening oversight of government-controlled firms with large liabilities, lengthening the loan maturity profile, and increasing reliance on domestic capital sources and peso debt. (In September 2010, the government raised $1 billion from its first sale of peso-denominated global bonds. The issue, whose bonds mature in 2021, was heavily oversubscribed and priced to yield 5.0%).

The new administration intends to promote public–private partnerships to build infrastructure and to revamp the institutional and governance framework to encourage these arrangements; to enhance social safety nets and basic social services, and to streamline business-registration procedures.

More immediately, it proposes to pull back the fiscal deficit to 3.2% of GDP in 2011. While slowing the growth of public spending overall next year, the new government plans to put greater emphasis on social services, raising outlays on social services by about 14% to just over one-third of its total spending. The budget for education will increase by 18% (the largest rise in over a decade). The conditional cash transfer program will be

3.8.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	3.8	6.2	4.6	4.6
Inflation	4.7	4.5	4.5	4.4
Current acct. bal. (share of GDP)	3.3	4.0	3.2	3.3

Source: ADB estimates.

expanded to include more poor households, and government-paid health insurance coverage will be broadened to cover more poor families and workers in the informal sector.

National government spending on infrastructure will be reduced by about 10% in 2011 in expectation of increased private sector participation. The government is planning to implement a number of projects in transport and utilities under public–private partnerships next year.

On the basis of inflation remaining within the central bank's target range (3%–5% for 2011), the outlook assumes that monetary policy will remain accommodative for some time, as policy interest rates only gradually edge up to more normal levels.

Signs are positive for continued growth in private consumption and investment. Surveys on consumer and business expectations conducted in the third quarter of 2010 showed gains in indexes of confidence (Figure 3.8.7). Business confidence was bolstered by the stronger domestic and external demand, the smooth political transition after the May elections, and optimism over the new administration. An increasing number of firms indicated that they would expand production and employment.

Consumption will continue to draw support from remittances; indeed, the central bank now expects remittances to increase by 8% to $18.7 billion this year (Figure 3.8.8), raising its forecast from 6% previously. Investment is underpinned by strong business and consumer confidence, rising capacity utilization, and low interest rates. This is reflected in the rising stock market (the share price index rose by 31.2% from end-2009 to mid-September, when it reached a record high), and growth in bank lending. Investment approvals by the Philippine Economic Zone Authority and the Board of Investments, which cover most investment pledges, nearly trebled to about $5 billion in the first half of 2010 from the weak prior-year period.

From the production perspective, manufacturing is expected to maintain solid growth, although it will likely slow from double-digit rates recorded in the first half of 2010 (Figure 3.8.9), when the low-base effect boosted growth. Private construction will continue to benefit from remittance inflows. The rebound in external trade, robust consumption spending, and pickup in investment will be reflected in growth in services. Agriculture could perform better than the first 6 months of this year, although a forecast La Niña weather pattern could produce excessive rainfall and so damage crops later this year.

Economic recovery will decelerate in the second half of 2010, mainly because the low-base effect will fade and inventory rebuilding will level off. The overall global economic environment is expected to weaken as evidenced by the slowdown in the growth of US and Japan in the second quarter of 2010. Seeming to corroborate this, the growth in the value of merchandise imports pulled back sharply to just 1.4% in June from over 31% in May, while the growth in factory output has broadly decelerated.

Taking these factors into account, GDP is projected to expand by 6.2% in 2010, revised up from *ADO 2010* because of the stronger than expected rebound in trade and investment. In 2011, growth is forecast to ease to 4.6% (Figure 3.8.10) as a consequence of base effects and reduced policy stimulus at home and abroad.

3.8.7 Confidence indexes

Source: Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph (accessed 16 September 2010).

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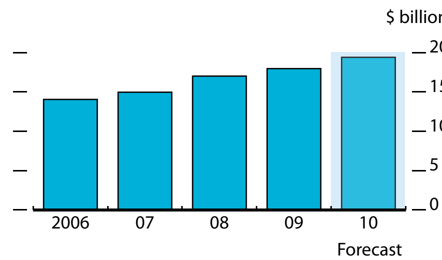
3.8.8 Overseas workers' remittances



Sources: Bangko Sentral ng Pilipinas.*The Philippines: Creating Opportunities through Effective Governance*. http://www.bsp.gov.ph; CEIC Data Company (accessed 10 September 2010).

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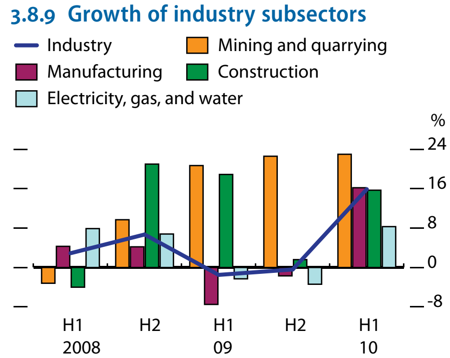
3.8.9 Growth of industry subsectors



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 27 August 2010).

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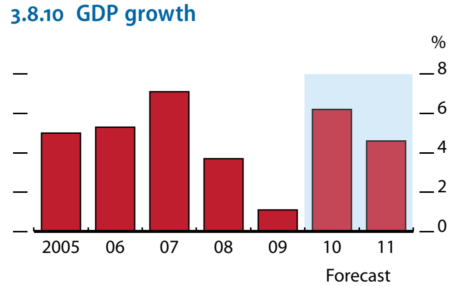
3.8.10 GDP growth



Source: Asian Development Outlook database.

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Inflation will continue to pick up through this year as the economy's output gap closes, and utility and transport prices rise. It is expected to average 4.5% for 2010. This is lower than the forecast made in April mainly due to moderate increases in food prices. Upward pressure on rice prices caused by the dry weather in the first half has been countered by an increase in rice imports (Figure 3.8.11). Contracted rice imports for this year are up by 43% from 2009, and by early August 2.1 million tons, or 94% of the total volume contracted for 2010, had arrived.

The firm peso will also exert downward pressure on prices. In 2011, expected moderate increases in global energy and commodity prices, coupled with slower domestic economic growth and reduced policy stimulus, will likely put inflation at about 4.4% (Figure 3.8.12), slightly lower than forecast in April.

Remittances and earnings from business process outsourcing will contribute to current account surpluses of about 4% of GDP in 2010 (revised up from the April forecast due to stronger than expected merchandise exports), and 3.3% in 2011.

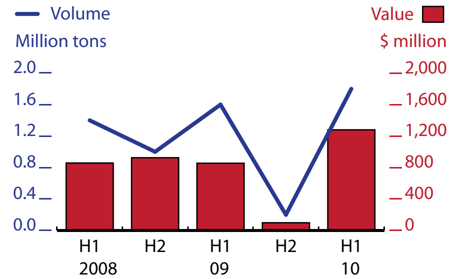
One key challenge for the government is to improve revenue collection so as to support social and development spending, which have lagged for many years. The new administration has said it will avoid increasing taxes or introducing new taxes, so that raising revenue depends heavily on strengthening tax administration.

On the expenditure side, public service wages and benefits (29% of total expenditure in January–July) have risen, mainly due to newly legislated salary increases for the public service, while interest on the public debt accounts for one-fifth of all expenditure, crowding out development spending. National government outstanding debt remains elevated, equivalent to about 57% of GDP (Figure 3.8.13).

A second challenge is to upgrade the investment climate. This enhancement is needed to encourage the creation of new businesses and employment, which is currently inadequate to absorb the growing labor force. The relatively low level of private investment in recent years is attributed to infrastructure deficiencies as well as to weaknesses in governance and in the policy climate.

Risks to the 2010–2011 forecasts come from uncertainty over the strength and pace of the global economic recovery and a stronger than anticipated La Niña weather disturbance that could hurt agriculture. Despite balance-of-payments surpluses and substantial foreign reserves, financial markets could become unsettled if fiscal slippage continues, raising the country's risk premium.

3.8.11 Rice imports



Note: First half 2010 volume figures for January–May 2010 only.

Source: CEIC Data Company (accessed 8 September 2010).

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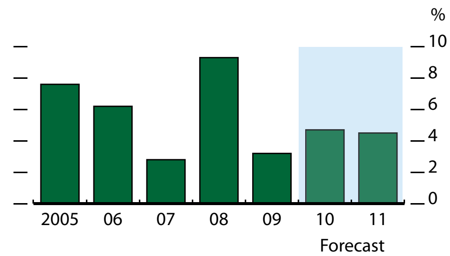
3.8.12 Inflation



Source: Asian Development Outlook database.

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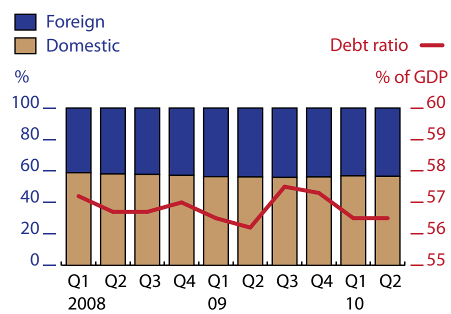
3.8.13 National government outstanding debt



Source: CEIC Data Company (accessed 9 September 2010).

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